WILSHIRE CONSULTING

Rosalind M. Hewsenian
Managing Director

July 27, 2006

Russell Read, Ph.D., CFA
Chief Investment Officer
California Public Employees' Retirement System
400 Q Street
Sacramento, CA 95814

Re: Fiscal Year 2006-2007 Incentive Compensation Plans

Dear Russell,

You had requested Wilshire's opinion with respect to the new incentive compensation plans for the Investment Office. Wilshire has reviewed the plans and supports their approval for this year. However, we also have recommendations for how to continue to improve them in the future.

Discussion

The most significant change for the new incentive compensation plans is to increase the percent of the quantitative measure allocated to the Total Fund return result for the SIOs to 25% from 10%. Wilshire strongly endorses this change because the most important return achieved by CalPERS is the Total Fund return as it is what is ultimately used to pay benefits, CalPERS most important objective. Thus, focusing more strongly on the Total Fund return aligns the interests of the senior investment officers with the overriding objective for CalPERS as a pension system.

Further, this change creates a stronger incentive to improve the nexus between the Board's strategic asset allocation policy and the implementation of that policy. This point will be discussed in more detail in a later part of this opinion.

Some of the SIOs have looked to this change in their own plans to effect changes in those of their direct reports by increasing the percent of the quantitative measure weighted to the asset class return. Again, Wilshire strongly supports this change.

We have other points to make with respect to improvements:

- Wilshire's chief concerns about the Investment program and by extension the Incentive Comp Plans are:
  - There is little nexus between the Board approved asset allocation and the implementation of the Investment Program with respect to achieving the Total Fund Return. The Total Fund return falls out of the amalgamation of the individual programs within the asset classes. This has been caused by a "bottom up" approach to investment planning and implementation.
  - We agree with and strongly support increasing the weight of the Total Fund return results to 25% for the SIOs incentive comp plans, as stated above, but there needs to be a Total Fund Investment Implementation Plan that achieves the Total Fund return. We are concerned about increasing the weight of the Total Fund return before this plan is in place, but we are more concerned that the plan will not happen if the weight of the Total Fund return in the SIO incentive compensation plans is not increased.

- The ultimate goal is for internal consistency between the Board's Total Fund Investment Objective, the policies, the performance objectives, the incentive compensation plans and the performance reporting. This is a larger issue than just the incentive compensation plans, but the review of all of the investment policies that is being undertaken under the leadership of the Assistant Executive Officer for Investments should ultimately lead to ensuring this consistency. Achieving this consistency should eliminate most of Wilshire's concerns about the plans.

- Another concern we have is that the quantitative measures are too finely parsed, especially at the SIO level and should be consolidated. An example of what CalPERS should strive for is how the plan for the SIO of AIM is constructed. Compare it to the SIO for Global Equity. The more finely parsed the quantitative measures the greater the risk the asset class could under-perform its objective, yet the SIO could receive an incentive bonus because some of the measures may be positive even thought the most important measure may be negative. The appropriate consolidation level should derive from the resolution of the internal consistency issues raised in the bullet point above and from a Total Fund Implementation Plan.

Conclusions

Wilshire strongly supports the incentive compensation plan concept at CalPERS and recommends that the plans for 2006-2007 be approved. Appropriate compensation is a tough issue as evidenced by the amount of time CalPERS spends on the matter of executive compensation through its Corporate Governance Program. If the answer was easy this would not be such a big governance issue. Wilshire has already met with you to discuss these points. You were the architect behind increasing the percentage weight of Total Fund return in the SIOs' incentive compensation plans and we applaud you for it. We recognize that the suggestions we have made shall take time to implement, but we stand ready to assist you in that endeavor.

Should you have any questions or require anything further, please do not hesitate to contact us.

Sincerely,